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October 7, 2005

## VIA HAND DELIVERY

Chairman Ron Jones  
c/o Sharla Dillon, Dockets Manager  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
Nashville, Tennessee 37243-00505

Re: Docket 04-00402 Summary of the Transactions in Chattanooga Gas Company's Deferred Gas Cost Account for the Twelve Months Ended June 30, 2004 and the Computation of the ACA Factor Effective January 1, 2005

Docket 04-00403 Chattanooga Gas Company's Report of Actual Gas Costs and the Applicable Index Cost for Each Month of the Plan Year Ended June 30, 2004

Dear Chairman Jones:

Enclosed please find the original and thirteen (13) copies of Chattanooga Gas Company's Response to the Utilities Division's Compliance Audit Report for filing in the above-referenced dockets.

Sincerely,

J.W. Luna

Enclosures

cc: Elizabeth Wade, Esq.  
Archie Hickerson  
Steve Lindsey

**BEFORE THE TENNESSEE REGULATORY AUTHORITY**

**NASHVILLE, TENNESSEE**

**October 7, 2005**

**IN RE:**

**CHATTANOOGA GAS COMPANY**

**ACTUAL COST ADJUSTMENT AUDIT AND**

**PERFORMANCE-BASED RATEMAKING TARIFF**

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**Docket No. 04-00402**

**Docket No. 04-00403**

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**RESPONSE OF CHATTANOOGA GAS COMPANY TO THE  
UTILITIES DIVISION'S COMPLIANCE AUDIT REPORT**

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Chattanooga Gas Company ("CGC" or "Company") respectfully submits the following response to the September 9, 2005 Notice of Filing by the Utilities Division of the Tennessee Regulatory Authority ("Audit Report" or "Report") in the above-captioned dockets. The subject of the Audit Report includes both the Company's compliance with the Actual Cost Adjustment and Refund Adjustment of the Purchased Gas Adjustment Rule of the Tennessee Regulatory Authority ("TRA" or "Authority") and with the Performance-Based Ratemaking Tariff ("PBR," "Incentive Plan," or "IPA") for the year ended June 30, 2004.

The purpose of this response is to address the findings, conclusions, and recommendations of the Utilities Division ("Staff") related to the use of index pricing under the Asset Management and Agency Agreement and Gas Purchase and Sale Agreement (attached as Exhibit C to AMA) between Chattanooga Gas Company and its affiliate Sequent Energy Management, L.P. ("Asset Management Agreement" or "AMA") for purchases other than NORA purchases; the Staff's proposal to hire a

consultant to assist the Staff with conducting the next annual audit of the Company's Actual Cost Adjustment filing and Incentive Plan filing; and the Staff's concerns about the transparency of affiliate transactions and the absence of affiliate rules for the Company.

For the reasons described herein, CGC respectfully requests that the Authority reject Staff's Finding #1 regarding the use of index pricing and allow the Company to continue to operate under its current Asset Management Agreement with Sequent Energy Management, L.P. ("Sequent") in accordance with its tariff.<sup>1</sup> The Company takes no position on the Staff's proposal to hire a consultant to assist in the audit of the Company's next ACA filing except to note the additional economic burden that will be placed on customers under the Staff's proposal. The Company, however, objects to any such consultant's involvement with the IPA filing since the purpose of the Incentive Plan is to waive a prudence audit by an outside consultant if certain benchmarks are achieved. The Company further requests that the Authority reject Staff's recommendations to adopt affiliate rules for CGC and to require CGC to place all contracts out for bid using the RFP process.

## **DISCUSSION**

- I. The Company respectfully submits that it is standard industry practice to price gas purchases at the index price and that index pricing is appropriate under the Company's tariff. Thus, Staff's Finding #1 should be rejected.**

In Finding #1 of the Audit Report, Staff challenges the practice of charging CGC the index rate for purchases other than NORA purchases instead of actual costs. Effective

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<sup>1</sup> The Audit Report contains four Findings. CGC concurs with Findings #2 and #4. In Finding #3, the Staff states that it has elected to accept the Company's numbers and defer an in depth review of the credits for the Company's IMCR filing until the next audit period. The Company has responded in good faith to all data requests and will continue to work with the Staff to provide information regarding its procedures and systems for tracking and documenting gains realized from the Asset Management Agreement.

April 1, 2004, a new Asset Management and Agency Agreement was entered into between CGC and Sequent. This agreement stipulates that all sales made by Sequent to CGC will be priced at the applicable indices, namely “FOM Index price” as published by Platts in the “Inside FERC’s Gas Market Report” or “Gas Daily prices” as published by Platts in the “Gas Daily.” Since there are no indices for the NORA receipt point on East Tennessee Natural Gas, purchases at this point are priced at Sequent’s actual cost. Approximately 5,000 decatherms per day are delivered to the NORA receipt point November through March.

In the Audit Report, the Staff insinuates that CGC has acted improperly by commencing this new Asset Management Agreement without first filing the agreement for review and approval by the Authority. (Report at 12.) It appears that the Staff believes that the decision to commence the Asset Management Agreement with a new pricing method should have been approved by the Authority. (Id.)

In 2004 when the Asset Management Agreement commenced, there were no rules, orders, or policies that required the utility to obtain the Authority’s approval prior to commencement of a new agreement. It was only after the Authority voted unanimously on December 13, 2004 during the panel’s consideration of the Company’s 2003 ACA Audit (Docket 03-00516) and then issued its final order on May 6, 2005, that the Company was required to file new affiliate asset management agreements with the Authority prior to commencement. As the new Asset Management Agreement with Sequent commenced prior to this new TRA approval requirement, the Company was not required to seek the Authority’s approval of the agreement and index pricing method.

Thus, the Company has not acted improperly or contrary to the Authority's rules or orders in place at the time that its new Asset Management Agreement commenced.

Pricing at index is standard industry practice as this commodity pricing mechanism is in practically every asset management transaction in the natural gas industry. In fact, Sequent's contracts with its other affiliates all employ this pricing methodology. The rationale for index is that Index is representative of all market trades done at a specific location. If Sequent priced all transactions to CGC at actual cost, it is likely that CGC costs would be above index as Sequent would be required to purchase non-standard volumes and need immediate market orders filled, causing the need to pay a premium to index.<sup>2</sup>

In order to mitigate Staff's concerns and to allow for Staff to monitor the use of index pricing for sharing calculation purposes, Sequent proposes to report the actual costs for all monthly gas purchases made by Sequent based on FOM Index Price for each of the pooling points where CGC has firm receipt entitlements. The actual cost will be reflected as a premium or a discount to the index. Sequent will also maintain data that will allow Sequent and/or Staff to compute the actual cost of its daily purchases for each of the pooling points where CGC has firm receipt entitlements.

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<sup>2</sup> In addition, Sequent systems are unable to perform the calculations required to charge CGC the weighted actual average costs incurred by Sequent's portfolio

**II. Staff's Recommendation No. 1 - The Company takes no position on Staff's recommendation to hire a consultant to assist in the next audit of the Company's ACA filing except to note the increased economic burden that Staff's proposal will place on customers during a period when customers are already facing at least a forty percent (40%) increase in natural gas costs. The Company, however, objects to the recommendation that the consultant should assist with the audit of the IPA filing.**

While the Company takes no position on the Staff's recommendation to hire a consultant to provide the Staff with additional expertise to conduct the 2005 ACA audit, the Company recommends that for long term efficiency the Staff develop in house expertise. The Staff is capable of understanding and analyzing the asset management and gas procurement transactions conducted on behalf of CGC. The Company again offers for the Staff to visit Sequent's offices in Houston, Texas, and observe Sequent perform both asset management and gas procurement transactions. The Staffs of the Virginia State Corporation Commission and the Georgia Public Service Commission have conducted on-site audits. Both CGC and Sequent believe such on-site visits would assist the Staff in better understanding and developing the expertise regarding the procedures and systems that Sequent has implemented to ensure the transparency of the affiliate transactions with CGC and other affiliated utilities.

If the TRA determines that its Staff needs the assistance of an outside consultant with additional expertise to properly complete a review of the Company's 2005 ACA filing required under TRA Rule 1220-4-7-.03(2), the Company does not object to the engagement of a qualified consultant to supplement the Staff. The Company, however, believes that it should be an active participant in the selection of such a consultant and in defining the scope of the audit, and that the consultant should be prohibited from disclosing confidential third party and/or trade secret data. Although the Staff does not

address the method of paying for the outside consultant's fees and expenses, the Company assumes that the Staff continues to advance the position taken in its 2003 Audit Report (Docket 03-00516) that the consultant's fees and expenses should be reimbursed to CGC by the ratepayers in the Actual Cost Adjustment.<sup>3</sup> It is important to note the increased economic burden that the cost of Staff's recommendation will place on the Company's customers in addition to the expected forty percent (40%) or greater increase in natural gas prices during the 2005 audit period.<sup>4</sup>

The Company questions the use of a consultant to assist in the audit of its "Incentive Plan." The Company does not have an Incentive Plan in place; instead, the Company's tariff includes a Performance-Based Ratemaking provision that provides for a waiver of the required consultant audit under TRA Rule 1220-4-7-.05 if gas purchases fall within specified benchmarks. CGC would object to the consultant participating in an audit of its PBR filing to the extent that its gas purchases fall within the specified benchmarks. To find otherwise would negate the intent of the PBR.

**III. Staff's Recommendation Nos. 2 and 3 – The Company submits that its current affiliate arrangement provides protections for its customers that far exceed any potential benefits achieved by modifying the Company's tariff to include affiliate rules, such as a bidding requirement.**

The Company does not believe that it is appropriate to modify CGC's tariff to include affiliate rules governing the selection of an asset manager and all affiliate

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<sup>3</sup> In addition, the Company's expenses associated with such an audit should also be reimbursed by ratepayers through the PGA/ACA. It has been the Company's experience that adding up the costs of outside consultants and time required by all parties to adequately respond to the requirements of the audit easily can exceed several hundred thousand dollars.

<sup>4</sup> As explained in Section I above, if the Authority requires CGC to pay actual costs instead of index prices for gas purchased, it is likely the Company's customers will experience an even greater increase in rates than the significant increases that they will experience in the aftermath of hurricanes Katrina and Rita. In the current market, there have been significant increases in the index premiums that are required to purchase gas based on index pricing. Some supply locations are so constrained by the current tight gas supply conditions that gas supply is not even available at any price.

transactions. In fact, the current sharing arrangement with Sequent provides protections for CGC's customers and the TRA that ensure transparency and far exceed any potential benefits resulting from bidding the agreement.

First, the current arrangement ensures that customers benefit from the asset manager's ability to maximize profits. Under the present provision, 50% of the gain from all non-jurisdictional transactions that are dependent on CGC's gas supply assets is shared with ratepayers. The gain realized from such transactions is dependent on market conditions and can vary greatly from year to year. The present procedure allows such an increase in the gain to be captured for the benefit of the customer. In 2004, the customer's share of the AMA was \$1,808,648.88.

If the TRA should require the Company going forward to place all contracts out for bid using the RFP process, the result would likely be a fixed fee arrangement similar to the one that was in place during the period of May 1, 2001 through December 31, 2002, to which the Staff has objected (Docket 03-00516). In a fixed fee arrangement, customers receive a fixed payment that would not reflect a change in the conditions that represent ongoing market value of the assets, e.g. customers would likely receive less money. In 2001, the Company entered into an agreement that provided it with a fixed payment based on the results from recent periods' off-system sales. When the Company recognized that conditions were changing and that there was potential for additional benefit to be captured, the Company terminated the agreement and required a 50/50 sharing of the gain from all non-jurisdictional transactions. Bidding opens the ratepayers up to the risk that the competitive bidding process may yield a contract under which the ratepayers see less value.



Second, the current sharing arrangement ensures transparency. Under the current procedure, records are being maintained that allow all of the non-jurisdictional transactions to be tracked, reviewed and analyzed by the TRA Staff during its annual audit. Under a fixed fee arrangement, tracking would not be necessary, and the records maintained by a non-regulated entity would not necessarily be available to the Staff.

Third, under the current sharing arrangement, CGC retains operational control of its assets, including the ability to recall any of its assets at any time if needed for firm customers. A non-affiliate would not necessarily provide this safeguard.

Fourth, due to the fact that an asset manager over time becomes more familiar with the CGC system needs and requirements, longer term contracts are also better for the ratepayers. When a new asset manager takes over, the new asset manager will have little knowledge of the system. Furthermore, a longer term agreement allows for the asset manager to enter into longer term deals with third parties to better leverage the assets of CGC and bring more value to the shared book. History shows that CGC's ratepayers have realized an increase in benefits each year under the current AMA which would be placed at risk if asset management was placed out for bid under an RFP process.

However, if the TRA believes that affiliate rules are necessary, CGG believes it would be more appropriate to address this issue in the current Generic Docket (05-00046), which would ensure that all interested parties have an opportunity to comment and that all companies are treated consistently. Further, any implementation of affiliate rules should not be put in effect until the expiration of the current Asset Management Agreement.

**IV. Staff's Recommendation No. 4 – The Company submits that the open bidding process does not ensure that ratepayers will receive greater benefits than the Company has been able to achieve under its current AMA. Thus, the Company requests that the Authority reject Staff's proposal that all of the Company's contracts going forward be placed out for bid.**

As explained above in Section III, CGC has been able to obtain better gains and benefits for its customers through the negotiated asset management agreement with its affiliate than any potential benefits it may have obtained through bidding the agreement. In response to the Staff's concerns about the TRA's ability to regulate natural gas companies consistently, the Company believes that the Generic Docket (05-00046) would allow all interested parties to have an opportunity to comment on bidding requirements and any resulting requirements would be consistent for all utilities.

In the event the Company is ordered to have an open bid process for a fixed-fee or other asset management agreement that would be effective at the termination of the existing Asset Management Agreement, the Company strongly urges that there be no preclusion of any party to submit a non-preferred good faith bid, including the affiliates of the Company.

**CONCLUSION**

In conclusion, the Company respectfully requests the Authority to reject Finding #1 and allow its current Asset Management Agreement to remain in effect unmodified. The Company further requests that the Authority reject Staff's recommendations to adopt affiliate rules for CGC and to require CGC to place all contract out for bid. While the Company takes no position on the Staff's recommendation to hire a consultant to assist with an audit of the Company's next ACA filing, the Company is concerned about the

additional economic burden that will be placed upon its ratepayers at a time when its ratepayers are already facing a very large increase in gas costs.

Respectfully submitted,

FARMER & LUNA, PLLC

By: 

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*Attorneys for Chattanooga Gas Company*

### **CERTIFICATE OF SERVICE**

I hereby certify that a true and exact copy of the foregoing has been forwarded by hand delivery on this the 7th day of October, 2005, to the following:

Ron Jones, Chairman  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
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J. Richard Collier, Esq.  
General Counsel  
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